Report of the Independent Auditors

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

November 16, 2009

Honorable Arne Duncan
Secretary of Education
Washington, D.C. 20202

Dear Secretary Duncan:

The enclosed reports present the results of the annual audits of the U.S. Department of Education's financial statements for fiscal years 2009 and 2008, to comply with the Government Management Reform Act of 1994 (GMRA). The reports should be read in conjunction with the Department's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of the Department as of September 30, 2009 and 2008, and for the years then ended. The contract required that the audits be performed in accordance with U.S. generally accepted government auditing standards and OMB's bulletin, *Audit Requirements for Federal Financial Statements.*

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the Department's financial statements, or conclusions about the effectiveness of internal control, whether the Department's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Sincerely,

/s/

Mary Mitchelson (Acting)

Enclosures

The Department of Education's mission is to promote student achievement and preparation for global competitiveness by fostering educational excellence and ensuring equal access.

Ernst & Young LLP
8484 Westpark Drive
McLean, VA 22102

Tel: 703-747-1000
www.ey.com

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2009 and 2008, and the related consolidated statements of net cost, and changes in net position, and the combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04*, Audit Requirements for Federal Financial Statements*, as amended. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Department's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2009 and 2008, and its net costs, changes in net position, and budgetary resources, for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued our reports dated November 13, 2009, on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

ERNST & YOUNG

Report of Independent Auditors
Page 2

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management's Discussion and Analysis, required supplementary stewardship information, required supplementary information, and other accompanying information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. The other accompanying information has not been subjected to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no opinion on it. For the remaining information, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

November 13, 2009

Ernst & Young LLP
8484 Westpark Drive
McLean, VA 22102

Tel: 703-747-1000
www.ey.com

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2009, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 13, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04, as amended. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined below. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies in internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described below to be significant deficiencies in internal control over financial reporting.

SIGNIFICANT DEFICIENCIES

1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be maintained and further refined to ensure that appropriate estimates are prepared.

During FY 2008, the *Ensuring Continued Access to Student Loans Act of 2008* (ECASLA) legislation was enacted, which amended the FFEL program and provided the Secretary of Education with the authority to purchase student loans from private lenders and enter into forward commitments to purchase FFEL loans. In October 2008, the enactment of Public Law (P.L.) 110-350 extended this temporary loan purchase authority through September 30, 2010. The Department assembled a team with representatives from throughout the organization to develop, document, and implement the necessary processes surrounding the activities of the temporary loan purchase authority. Representatives included individuals from the Office of the Under Secretary, Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), Budget Service, and Office of the General Counsel (OGC). We noted that the Department implemented, accounted for, and maintained these challenging activities throughout FY 2009, with significant activity under the programs occurring in the last quarter of the fiscal year.

Management informed us that team representatives maintained communication throughout FY 2009 on both the activities related to the temporary loan purchase authority and the development of loan volume estimates and the subsidy re-estimates for all loan programs. Discussions relating to the temporary loan purchase authority activities also played an important role in developing the re-estimates for the existing direct loan and FFEL guaranteed loan programs, since all the programs are interrelated. In contrast to efforts documented from prior monthly integrated loan program meetings or subgroups or full workgroup sessions of the prior Credit Reform Workgroup, these meetings occurred on an informal basis, and limited documentation of their activities was developed. To the extent such groups execute critical review activities, they constitute a key control for the Department, and further structure around their activities can enhance confidence in the Department's estimation processes.

ERNST & YOUNG

After identifying the challenges faced by the Department and improvements in communication made or currently being made by the Department, we noted the following items that indicate management controls and analysis can be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the receivables related to the direct loan (DL) program and the temporary loan purchase authority, and in the liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of complex assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM also produces a forecast of the expected cash flows in the current year for the outstanding loans which, when discounted, can be used to compare to the recorded activity in the general ledger. Additionally, other data analysis tools prepared by the Department, such as the cohort analysis, support more disaggregated reviews of data by cohort. The Department's financial systems are not configured to account for cash flows on a precise cohort level. Rigorous examinations using the cohort analysis data as well as comparisons using the backcast and forecast tools, and to the extent practical, recomputation of expected amounts based on loan volumes, interest rates, and simplified cash flow assumptions, can serve as key detect controls for potential undetected errors that may exist in the development of the assumption data and credit reform estimates. In some instances, we noted calculation errors in certain of the analytical tools used by the Department, including the cohort analysis, back of the envelope, and fluctuation analysis. While these errors did not impact amounts in the financial statements, the analytical tools should contain accurate information if they are to serve their purpose as a detect control. In addition, we noted no formal detail review process surrounding these tools. Implementing such a process may reduce the potential for errors occurring in the analytical tools, lead to further refinement of the tools, and facilitate their use in a reinvigorated and more formalized cross-functional review of the estimates.

- Consistent with credit reform implementation guidance, the Department relies significantly on prior patterns to estimate future cash flow activity. However, the Department should be more proactive in identifying conditions in which a refinement of such estimates should be made when circumstances suggest that fundamental patterns will change. For example, to the extent that lender or borrower behavior appears likely to have changed, or be changing, deviations from the use of historical data, or consideration of additional information to capture the impact of such changes, may be warranted in developing credit reform estimates. The current recessionary conditions, including

ERNST & YOUNG

increases in unemployment, reductions in credit availability for borrowers, and declines in home prices may have a significant impact on student loan borrowers and consequently on the Department's credit reform results. Many of these impacts have not been explicitly reflected in the Department's estimates.

Since the Department's approach to estimating deferment, forbearance, and default rates includes unemployment and inflation rates for selected loan products, and since forecasts of these external factors are used in arriving at the projected deferment, forbearance, and default amounts, the Department's estimates would be expected to capture some of the indirect impact of the economic environment. However, since the models are estimated using data that largely do not reflect recessionary conditions and for a significant period reflect what in hindsight has been assessed to be a credit bubble, the Department could gain additional insights by performing stress-testing around its estimates and, as necessary, postulating borrower and lender behavior that may occur assuming the current economic recession lasts for varying lengths of time. This could be achieved by, for example:

- *Cohort Analysis.* Since differences may exist in how the events in the credit crisis and broader economic recession impact borrowers at various points in their career, examining deferment, forbearance, and default rates by cohort may be beneficial. This could be achieved by comparing the rates at the same point in repayment for newer loans to those of older loans, and attempting to project changes in deterioration into default status by examining the behavior of loans that experienced an early default, deferment, or forbearance during prior downturns in the economy. This exercise would provide information regarding the extent to which there may be differences in performance across cohorts. Obtaining credit rating data for a subset of borrowers may also be useful in furthering analysis and tracking borrowers' ability to pay over time.
- *Refinement of Tools to Reveal Trends in the Department's Loan Level Data.* We noted that the Department had made efforts to develop additional analytical tools utilizing the considerable data available to it, and is continuing the process to refine these tools and reports to aid in detecting trends. We also noted that the Department has made efforts to capture the impact of current economic conditions through the inclusion of an ad hoc variable in its model, which allows defaults for certain years to be at a different level than what would otherwise be predicted. Considering additional forms of stress-testing estimates or corroborating the default projections through alternative analysis could also aid the Department.
- *Unemployment Rate Forecast.* We noted that the Department's unemployment rate forecast appears to be somewhat lower than current unemployment rates. For example, the rate for FY 2009 is set to 6.77%, while monthly figures from the Bureau of Labor Statistics indicate that the unemployment rate reached 7.2% in December 2008 and has continued to climb throughout FY 2009. Considering alternative

ERNST & YOUNG

unemployment scenarios would allow the Department to test the sensitivity of the default estimates to the unemployment assumption. Such analysis may also provide useful information for stress-testing the Department's deferment and forbearance estimates, and, as warranted, aid in policy making to mitigate the impact of the current economic conditions on participants in the Department's programs and/or the costs of the programs.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process, working to develop formats and content that synthesize and capture loan level data available in the Department's systems. Specifically:
   - Critically assess default rates by cohort in light of recent changes in initial defaults, and increases in deferment and forbearance activity to determine the extent to which there may be differences in performance across cohorts.
   - For a subset of borrowers, obtain credit rating data and track the borrower's ability to pay over time. Utilize the results to further analysis.
   - Perform additional forms of stress-testing estimates, such as alternative unemployment, interest rate, GDP growth, and inflation scenarios.
   - Perform reviews of source data included in the Department's analytical tools to avoid errors and ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
2. Continue efforts to more fully implement cohort reporting with specific research on whether balances in the Department's financial records are supported by estimates, by cohort, from the SLM and the cohort analysis tool and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts. Beginning initially with direct loans, utilize detail loan level data in NSLDS to develop summary cohort level data for each year of outstanding balances for comparison to projected future cash flows from liquidation of the loans as reflected in the SLM and cohort analysis tool.
3. Document in detail the consideration and ultimate resolution of scenarios under which early warnings from patterns in Department data and other indicators of stress on program participants would be expected to lead to model adjustments in anticipation of likely changes in cash flows and result in changes in credit reform estimates. Similarly, capture the value of financial-related data for the programs to provide information for decision-makers regarding possible prospective changes in the programs based upon

indications of program participant performance, stress, and anticipated changes in behavior in response to changing market and economic conditions.

4. Reinforce the role of cross-functional teams, including members from OCFO, FSA, Budget Service, Office of Postsecondary Education (OPE), and OMB, in conducting integrated loan program meetings to review reports developed as part of the cohort analysis, critical assumptions in the models, and to discuss key internal issues and trends related to the portfolios. Document these activities and decisions reached in meeting minutes with copies of the distributed materials.

2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of the Department's FY 2009 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, the GAO publication states that:

- "Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and
- "Internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved."

While the Department has worked towards strengthening and improving controls over information technology processes during FY 2009, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems, that need to be addressed. During our review of information technology general controls at the Department and FSA, we identified the following deficiencies: (1) lack of monitoring of the activities of administrator

ERNST & YOUNG

accounts at the application, operating system, and/or database layers; (2) access for terminated users was not removed in a timely manner or not removed at all; (3) revalidation of users' rights is not consistently performed for all applications and users and for those revalidations that are performed, we noted instances in which there was no validation of the appropriateness of user access; (4) password configurations for applications, operating systems, and/or databases did not comply with the relevant Department or FSA policy; (5) documentation and related approvals required to provision user access are not consistently maintained; (6) administrator level access was assigned to individuals not requiring elevated privileges; and (7) documentation related to interfaces, including but not limited to Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding, were not up to date.

The OIG has identified information technology related deficiencies for the Department and FSA in reports issued during FY 2009. The OIG noted that the Department and FSA should improve security controls over the certification and accreditation (C&A) process for information systems to adequately protect the confidentiality, integrity, and availability of Department systems and the data residing in the system. In addition, OIG noted that the Department needs to improve security controls over its incident response and handling program and accelerate two-factor authentication for protecting Privacy Act information to adequately protect the confidentiality, integrity, and availability of the personally identifiable information (PII) data residing on public web sites. During the audit, OIG also identified significant conditions related to the work performed regarding Intrusion Detection System (IDS) configuration and public domain web site establishment and maintenance.

In addition, several of the above deficiencies are repeat conditions (although for different platforms or systems) that were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department require additional focus.

Recommendation:

Applications and related infrastructure are supported by a number of separate groups within the Department and FSA. While these groups have attempted to implement controls promulgated by Department, FSA, OMB, and NIST guidelines, control processes and practices continue to be implemented in a disparate manner across these groups. In addition, audit resolution activities have traditionally been performed by each separate group and have largely focused around addressing the immediate security and control weaknesses identified by audit reports.

We recommend that the Department continue its efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness uniformly across the organization, which should decrease the likelihood of a similar weaknesses being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, allocating appropriate resources and subject matter resources to the information technology process area, maintaining updated procedures to ensure proper configuration of servers against documented standards at the time of changes in the environment, and monitoring of contract performance of vendors providing system support services to the Department. As appropriate, the specific security and government standards that are to be applied, and approaches to achieving and monitoring such compliance, continue to merit additional focus in contracts the Department executes with service providers.

More specifically, the Department should: (1) implement standards around the logging of privileged user access and activities and establish controls over the monitoring of that access; (2) strengthen access controls to protect mission critical systems (e.g., periodic access revalidation, timely removal of user access, enforcement of changes in access due to changes in roles and responsibilities); (3) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with Department and FSA policy; (4) strengthen incident handling and response procedures; (5) enhance its security training and awareness program, specifically around actions to be taken in the event an employee encounters suspicious activity; (6) document and update, as required, information pertaining to system interfaces, including Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding; (7) update system security plans and other documentation related to the C&A of existing systems, including documentation to support the authorization to operate (ATO); and (8) perform Privacy Impact Assessments (PIA) for systems containing PII and improve security controls over the protection of PII.

3. Additional Focus on Controls and Financial Reporting Processes Related to the American Recovery and Reinvestment Act is Needed

The *American Recovery and Reinvestment Act of 2009* (ARRA) was enacted in February 2009 in response to the current recession in an effort to increase economic activity, create or save jobs, and improve accountability and transparency in government spending. The Department received approximately $98 billion in ARRA funding for job preservation, state and local fiscal stabilization, and advancing education reforms and improvements. Approximately 55% of the Department's ARRA funding was appropriated for the creation of a new State Fiscal Stabilization Fund with the goal of stabilizing state and local government budgets to avoid reductions in education and other essential public services while driving education reform. The Department was tasked with promptly disbursing these funds through a variety of existing and new grant programs, while ensuring transparency and accountability. The Department has implemented new internal controls and utilized a variety of existing controls in an effort to mitigate the risks surrounding the disbursement and monitoring of this funding.

The Department has taken steps to address cash management issues under ARRA. In particular, similar to other federal grant programs, funds should not be distributed to grantees until the funds are needed to pay for authorized program expenses. The time between a grantee receiving funds and disbursing them to pay approved program expenses should be minimized. As part of its disbursement process for ongoing grant programs, the Department has controls in place to identify and monitor unusual patterns of drawdowns by grantees, including system-generated reports of drawdown requests that will require approval by the appropriate program office before being paid. Management informed us that program office personnel did follow up with grantees if unusual amounts or patterns of ARRA funds were requested to be drawn in a short period of time. The Department's program offices, Risk Management Service (RMS) and OCFO, in consultation with the OIG and the OGC, have worked to provide technical assistance to state and local agencies regarding cash management.

For financial reporting purposes, the Department recognizes disbursements of grant funds as expenses at the time the funds are disbursed. Some grant recipients incur expenditures prior to requesting grant funds. The Department records an accrued grant liability estimate for expenses incurred by grantees prior to their receiving grant funds. Conversely, the Department should record an advance for funds disbursed to grant recipients where the grantee has not spent the funds for immediate cash needs.

While the Department has worked to quickly implement the requirements of ARRA, strengthen controls over the significant amount of ARRA funds it received, and address the financial reporting issues surrounding ARRA, we noted the following matters for improvement:

- The Department's OIG recently identified several areas of concern surrounding state educational agencies' (SEA) implementation of federal cash management requirements under ARRA (ED-OIG/L09J0007). The OIG noted instances where SEA cash management systems (1) disburse ARRA funds without adequate information on whether local educational agencies (LEAs) are ready to spend the funds and (2) do not ensure LEAs remit interest earned on ARRA funds received in advance of LEA needs.
- The Department has procedures in place to identify, calculate, and record liabilities that may arise from grant disbursing activities, through the use of an estimated grant liability accrual which is reported on the financial statements. The Department estimated a grant liability related to the ARRA. We inquired whether the Department had addressed in its financial statements potential advances that may have occurred when grantees received ARRA funding but did not spend them for immediate cash needs. The Department subsequently reviewed recipient reporting data provided by ARRA grant recipients and compared recipient-reported expenses to available funds received. The Department did

ERNST & YOUNG

not have the final recipient-reported data as of September 30, 2009 available until October 30, 2009 to identify and record any advances that may have occurred related to ARRA grant funding. During its review, if funds received exceeded expenditures, the Department classified the amount as an advance, while conversely classifying as a liability amounts where expenditures exceeded funds received. This additional analysis performed as of September 30, 2009 resulted in a reduction of the initial year-end accrued grant liability of approximately $550 million, and the establishment of a grant advance of nearly $350 million. While the circumstances surrounding ARRA disbursements and reporting are somewhat unique, the potential for cash advances in other programs exists.

Recommendations:

We recommend that the Department of Education perform the following:

1. Reinforce existing cash management policies to grantees to emphasize that funds should not be drawn down substantially in advance of expenses.
2. Proactively monitor procedures related to the Department's non-routine grant accrual process to identify whether refinements to the process are needed, including procedures to identify, calculate, and record potential advances arising from grant disbursing activities.

ERNST & YOUNG

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2008 audit of the U.S. Department of Education's financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Summary of FY 2008 Significant Deficiencies

Issue Area	Summary Control Issue	FY 2009 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Significant Deficiency)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Modified Repeat Condition classified as a Significant Deficiency
Controls Surrounding Information Systems Need Enhancement (Significant Deficiency)	Improvements are needed in overall information technology security and systems.	Modified Repeat Condition classified as a Significant Deficiency

We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 13, 2009

Ernst & Young LLP
8484 Westpark Drive
McLean, VA 22102

Tel: 703-747-1000
www.ey.com

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2009, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 13, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

The management of the Department is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04, as amended, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, as amended.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

ERNST & YOUNG

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. We have identified the following instance of noncompliance:

While the Department has worked towards strengthening and improving controls over information technology processes during FY 2009, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems, that need to be addressed. During our review of information technology general controls at the Department and Federal Student Aid (FSA), we identified the following deficiencies: (1) lack of monitoring of the activities of administrator accounts at the application, operating system, and/or database layers; (2) access for terminated users was not removed in a timely manner or not removed at all; (3) revalidation of users' rights is not consistently performed for all applications and users and for those revalidations that are performed, we noted instances in which there was no validation of the appropriateness of user access; (4) password configurations for applications, operating systems, and/or databases did not comply with the relevant Department or FSA policy; (5) documentation and related approvals required to provision user access are not consistently maintained; (6) administrator level access was assigned to individuals not requiring elevated privileges; and (7) documentation related to interfaces, including but not limited to Interface Control Documents, Trading Partner Agreements, and Memorandums of Understanding, were not up to date. The OIG has identified information technology related deficiencies for the Department and FSA in reports issued during FY 2009. The OIG noted that the Department and FSA should improve security controls over the certification and accreditation (C&A) process for information systems to adequately protect the confidentiality, integrity, and availability of Department systems and the data residing in the system. In addition, OIG noted that the Department needs to improve security controls over its incident response and handling program and accelerate two-factor authentication for protecting Privacy Act information to adequately protect the confidentiality, integrity, and availability of the personally identifiable information (PII) data residing on public web sites. During the audit, OIG also identified significant conditions related to the work performed regarding Intrusion Detection System (IDS) configuration and public domain web site establishment and maintenance.

Our Report on Internal Control dated November 13, 2009, includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives. We did not audit management's proposed action plan and, accordingly, we express no opinion on it.

ERNST & YOUNG

Report on Compliance with Laws and Regulations
Page 3

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 13, 2009

UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202-______

November 10, 2009

MEMORANDUM

TO: Mary Mitchelson
Acting Inspector General

FROM: Thomas P. Skelly Thomas P. Skelly
Delegated to perform functions of Chief Financial Officer

Danny Harris
Chief Information Officer

SUBJECT: DRAFT AUDIT REPORTS
Fiscal Years 2009 and 2008 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17J0001

Please convey our sincere thanks and appreciation to everyone on your staff who worked diligently on this financial statement audit. The Department has reviewed the draft Fiscal Years 2009 and 2008 Financial Statement Audit Reports. Without exception, we concur and agree with the Report of Independent Auditors and the Report on Internal Control. We also concur and agree with the Report on Compliance with Laws and Regulations.

We will share the final audit results with responsible senior officials, other interested program managers, and staff. At that time we will also request that they prepare corrective action plans to be used in the resolution process.

Again, please convey my appreciation to everyone on your staff whose efforts permitted the Department to compete the audit within the established timeframe. Please contact Gary Wood at (202) 401-0862 with questions or comments.

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.